

***United States Court of Appeals
for the Second Circuit***



APPELLEE'S BRIEF

w/affidavit

77-6095

To be argued by
THOMAS E. MOSELEY

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket No. 77-6095

AMERICAN TELEPHONE AND
TELEGRAPH COMPANY,

Plaintiff-Appellant,

—against—

UNITED STATES OF AMERICA,

Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR DEFENDANT-APPELLEE UNITED STATES OF AMERICA

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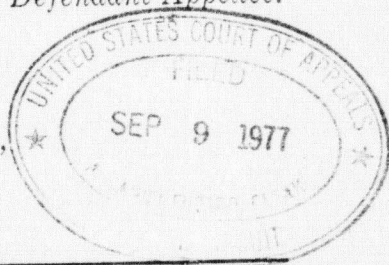


TABLE OF CONTENTS

	PAGE
Issues Presented	1
Statement of the Case	2
A. Proceedings Below	2
B. Statement of Facts	2
ARGUMENT:	
POINT I—The District Court properly construed 26 U.S.C. § 905 (c)	4
POINT II—The District Court's construction of 26 U.S.C. § 905 (c) properly implements the policy of the foreign tax credit	11
A. The District Court's construction avoids double taxation	11
B. Appellant has advanced no valid reason to sustain its construction of 26 U.S.C. § 905 (c)	15
CONCLUSION	21

TABLE OF CITATIONS

Cases:

<i>Associated Telephone and Telegraph Company v. United States</i> , 306 F.2d 824 (2d Cir. 1962), <i>cert. denied</i> , 371 U.S. 950 (1963)	11
<i>Bank of America National Trust & Sav. Ass'n. v. United States</i> , 459 F.2d 513 (9th Cir. 1972), <i>cert. denied</i> , 409 U.S. 949 (1972)	7

<i>Comprehensive Designers International Ltd. v. Commissioner</i> , 66 T.C. 348 (1976)	8, 11, 17
<i>Corwin Consultants, Inc. v. Interpublic Group of Companies</i> , 512 F.2d 605 (2d Cir. 1975)	11
<i>First National City Bank v. United States</i> , 77-2 USTC ¶ 9527 (Ct. Cl. 1977)	8, 11, 17
<i>Gould v. Gould</i> , 245 U.S. 151 (1917)	19
<i>Helvering v. Reynolds Co.</i> , 306 U.S. 110 (1939) ..	8
<i>Irving Air Chute Co. v. Commissioner</i> , 143 F.2d 256 (2d Cir. 1944), <i>cert. denied</i> , 323 U.S. 773 (1944)	20
<i>Levine v. Commissioner</i> , 526 F.2d 717 (2d Cir. 1975)	20
<i>Malat v. Riddell</i> , 383 U.S. 569 (1966)	6
<i>White v. United States</i> , 305 U.S. 281 (1938)	19
<i>Wolder v. Commissioner</i> , 493 F.2d 608 (2d Cir. 1974), <i>cert. denied</i> , 419 U.S. 828 (1974)	20

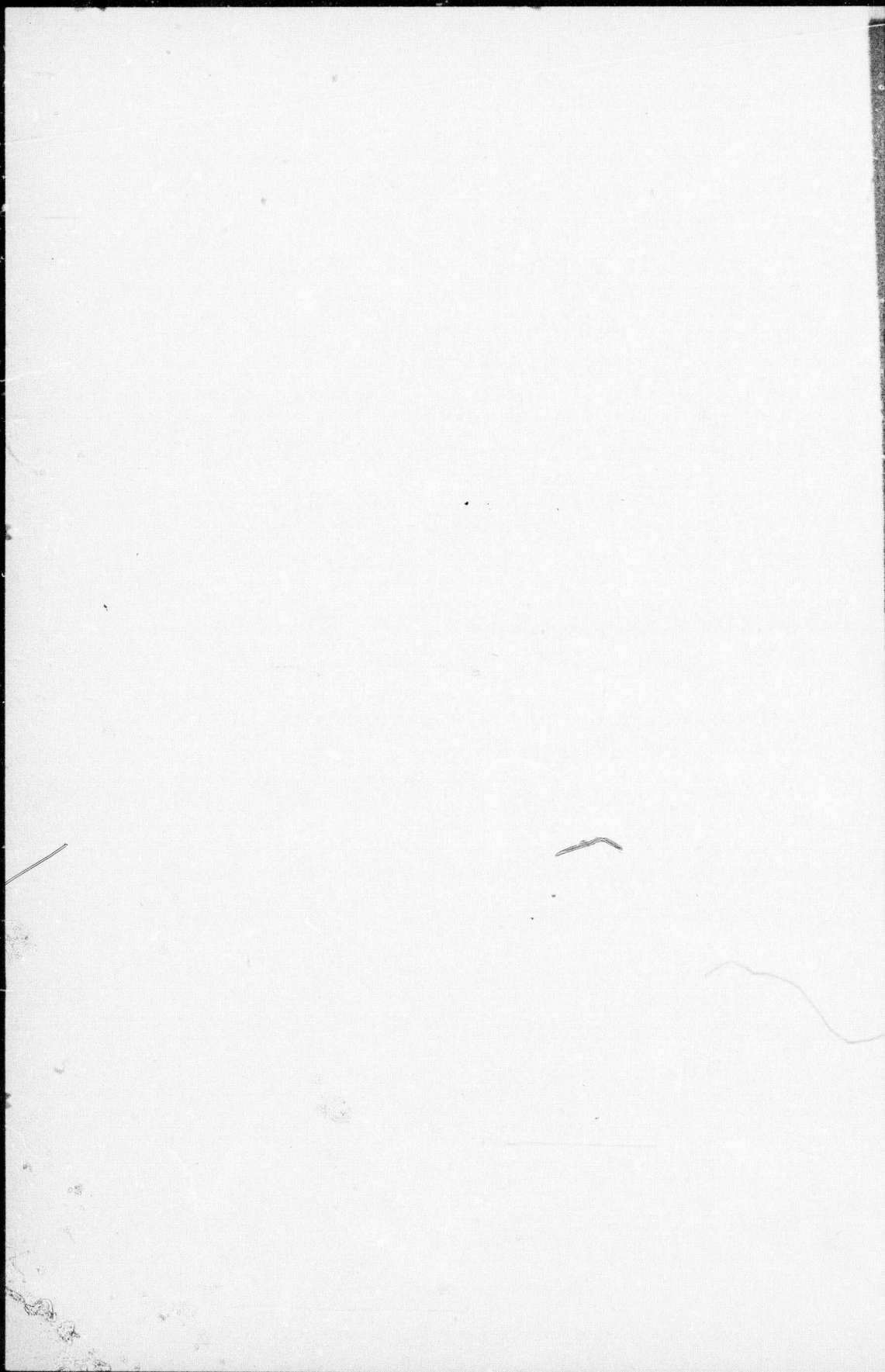
Statutes and Rulings:

26 U.S.C. § 111	17
26 U.S.C. § 901(b)	4, 5, 6
26 U.S.C. § 905(c)	3, 4, 5, 6, 9, 10, 17, 18
Internal Revenue Code of 1939, Section 131(c) .	7, 8
Revenue Act of 1918, Sections 222(b) and 238 (a)	6

	PAGE
Rev. Rul. 77-267, 1977-31 I.R.B. 16 (1977)	18
Rev. Rul. 76- 508, 1976-2 Cum. Bull. 225 (1976)	18
Rev. Rul. 58-237, 1958-1 Cum. Bull. 534 (1958)	7, 8, 9, 10
S.M. 4747, V-1 C.B. 282 (1926)	6, 8, 19
Can. Rev. Stat. c. 148, s. 106 (1952)	2

Other Authorities:

E. Owens, <i>The Foreign Tax Credit</i> (1961) . . .	8, 11, 13, 17
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Docket No. 77-6095

AMERICAN TELEPHONE AND TELEGRAPH COMPANY,
Plaintiff-Appellant,
—against—

UNITED STATES OF AMERICA,
Defendant-Appellee.

**BRIEF FOR DEFENDANT-APPELLEE
UNITED STATES OF AMERICA**

Issues Presented

1. After Canada had refunded a portion of appellant's income taxes for 1964, was the redetermination of appellant's 1964 federal tax liability required under 26 U.S.C. § 905(c) properly effected by subtracting the full dollar value of the refund from appellant's foreign tax credit for Canadian income taxes?

2. Does the District Court's application of 26 U.S.C. § 905(c) carry out the policy embodied in the foreign tax credit?

Statement of the Case

A. Proceedings Below

On February 4, 1976 American Telephone & Telegraph Company ("AT&T") commenced this action for a refund of federal income taxes pursuant to 28 U.S.C. § 1346(a)(1) and 26 U.S.C. § 7422 (3A-8A). After issue was joined (9A-10A), the parties filed a joint statement of undisputed facts pursuant to General Rule 9(g) on October 1, 1976 and then both moved for summary judgment (18A). The District Court granted the defendant's motion by an opinion filed on April 15, 1977 (24A-32A) and judgment was entered on April 18, 1977, dismissing plaintiff's complaint (33A).

B. Statement of Facts

The present case involves American Telephone and Telegraph Company's tax refund claim for its 1964 taxable year (4A, 8A). For that year AT&T obtained a foreign tax credit in the aggregate amount of \$976,944.39 (7A, 19A) with respect to its payment of an income tax imposed upon non-residents under the Canadian Income Tax Act, Can. Rev. Stat. c.148, s.106 (1952), which is set forth in the Statutory Appendix to this brief. The Canadian statute required non-residents to pay a 15% income tax upon certain enumerated items of income, including dividends, interest and royalties. AT&T paid these taxes to the Canadian authorities in Canadian currency and obtained its foreign tax credit based upon the United States dollar* value of that currency at the time of payment (13A-14A).

* Unless otherwise indicated, "dollar" and the "\$" symbol hereinafter will refer to United States currency not Canadian currency.

AT&T obtained its foreign tax credit of \$976,944.39 in two stages. When AT&T filed its 1964 federal income tax return, it claimed a foreign tax credit of \$269,085.10 based upon its payment of the Canadian income tax on non-residents for 1964 (19A). While AT&T's 1964 return was under audit by the Internal Revenue Service ("IRS"), Canada, in 1966, made an assessment against AT&T under the same Canadian tax statute for additional 1964 income taxes (19A). The amount of tax assessed was 763,272.90 in Canadian dollars, which AT&T paid the Canadian authorities on January 23, 1967 (19A). On that date, the exchange rate of United States dollars for Canadian dollars was .9274, which meant that the dollar value of AT&T's payment was \$707,859.29 (20A). As a result, AT&T claimed for its 1964 taxable year an additional foreign tax credit of \$707,859.29 based upon its payment of Canada's non-resident income tax (20A). This claim was allowed as an adjustment during the audit of AT&T's 1964 federal return and that gave AT&T a total foreign tax credit of \$976,944.39 from its payment of the Canadian income tax upon non-residents (7A, 20A).

On October 26, 1972, the Canadian authorities refunded a portion of the Canadian income tax that AT&T had paid with respect to its 1964 taxable year (20A). This partial refund was the 763,272.90 in Canadian dollars that had been assessed against AT&T subsequent to the filing of its 1964 federal income tax return and with respect to which AT&T had successfully sought a refund from the Canadian authorities (20A). On the date that this portion of the non-resident income tax paid by AT&T was refunded, the exchange rate of United States dollars for Canadian dollars was 1.0183 and the dollar value of the Canadian refund was \$777,240.79 (20A).

As required by Section 905(c) of the Internal Revenue Code, AT&T notified IRS of this partial refund

(21A). The IRS redetermined AT&T's 1964 federal income tax pursuant to Section 905(c) of the Code by deducting the refund of \$777,240.79 from the total foreign tax credit of \$976,944.39 previously claimed by AT&T with respect to its payment of Canada's income tax. AT&T has contested this redetermination, arguing that the IRS should have deducted only \$707,859.29. Accordingly, AT&T seeks a refund of \$69,381.50, the difference between the amount by which the IRS reduced AT&T's foreign tax credit and the amount AT&T maintains that the foreign tax credit should have been reduced.

ARGUMENT

POINT I

The District Court properly construed 26 U.S.C. § 905(c).

Under 26 U.S.C. § 901(b), a taxpayer is allowed a credit against his federal income tax in

the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country. . . .

At the same time 26 U.S.C. § 905(c) provides in pertinent part:

If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid [to a foreign country] is refunded in whole or in part, the taxpayer shall notify the Secretary or his delegate, who shall redetermine the amount of the tax for the year or years affected.

Appellant concedes that, in making its redetermination, the IRS should, as a general rule, subtract the dollar value of the refund from the foreign tax credit. See Brief for Plaintiff-Appellant ("Appellant's Brief") at 15.

AT&T argues, however, that its \$976,944.39 foreign tax credit for payment of Canada's 15% income tax should really be broken down into two separate tax credits because \$707,859.29 of that credit comes from taxes paid under Section 106(1)(d) of the Canadian Income Tax Act and \$269,085.10 comes from taxes paid under Section 106(1)(a) and 106(1)(b) of that statute. See Appellant's Brief at 15-16. Given such a break-down, according to AT&T, the accepted method of redetermination could not be employed, because, if it were, this would require the dollar value of the refund, \$777,240.79, to be subtracted from the \$707,859.29 tax credit and that would yield a negative number. Appellant's Brief at 13.

In rejecting AT&T's arguments, the District Court correctly held (26A-27A) that the redetermination of appellant's 1964 tax liability under 26 U.S.C. § 905(c) was properly done by subtracting the full dollar value of the Canadian refund from the total foreign tax credit based upon Canada's income tax. This result flows logically from an analysis and application of 26 U.S.C. §§ 901(b) and 905(c). Section 901(b) allows a foreign tax credit for the amount of income tax paid to a foreign government. Canada's 15% income tax on non-residents is just such a creditable tax for purposes of Section 901(b) and AT&T's payment of that tax in an amount worth \$976,944.39 earned it a foreign tax credit of \$976,944.39. Section 905(c), in turn, provides for a redetermination of tax with respect to a given year if "any tax paid" to a foreign government for that year is refunded in "whole or in part." Here the "any tax paid" was Canada's 15% income tax for which AT&T obtained a \$976,944.39 credit. Subsequently, Canada refunded that tax "in part" and the IRS then made a redetermination of AT&T's 1964 federal income tax by subtracting the dollar value of that refund from the foreign tax credit allowed AT&T with respect to its payment of the 15% Canadian income tax for 1964.

In short, the Government reads the phrase "any tax paid" in Section 905(c) as referring to the full amount of tax paid to a foreign government for which a credit was allowed under Section 901(b), which in this case was an income tax of \$976,944.39. Such an interpretation is consistent with the plain language of Section 905(c) and construes that language in harmony with Section 901(b). See *Malat v. Riddell*, 383 U.S. 569, 571-572 (1969). AT&T would, however, read "any tax paid" to mean only the tax paid a foreign government on a specific taxable transaction or item rather than the total tax for which a foreign tax credit was allowed. Appellant's attempt to make this phrase refer to different taxable events or items rather than to the entire tax paid runs counter to the plain meaning of Section 905(c) and should be rejected. See *Malat*, *supra* at 571-572. Moreover, AT&T's approach is inconsistent with Section 901(b) since "any tax paid" would be read to mean separate items of income tax rather than the entire amount of income taxes giving rise to the taxpayer's foreign tax credit.*

Not only was the method of redetermination upheld by the District Court in accordance with the plain meaning of Section 905(c), it is also in accordance with the published rulings of the IRS since 1926. In administering a section of the Revenue Act of 1918, 40 Stat. 1057, analogous to 26 U.S.C. § 905(c),** the IRS in S.M. 4747, V-1

* Section 901(b) allows a single foreign tax credit for the amount of income tax paid to a foreign government and does not contemplate several separate foreign tax credits because payments to the foreign government may have been extracted under different subsections of that country's income tax statute.

** The Revenue Act of 1918 had two sections analogous to Section 905(c) one with respect to corporations (Section 238(a)) and another with respect to individuals (Section 222(b)). These sections were virtually identical and in substance are the same as 26 U.S.C. § 905(c); they are reproduced in the Statutory Appendix. The ruling above was under Section 222(b).

C.B. 282 (1926) considered how a redetermination of tax liability was to be made following a refund of foreign taxes. The taxes in question had originally been claimed as a credit in 1920 and a portion of them was later refunded. This ruling required that for purposes of the redetermination, the refund should be translated into dollars at the exchange rate prevailing when it was received:

It is noted that the revenue agent converted the repayments received at 3.49, the rate used in determining the dollar value of the taxes which were claimed as a credit in 1920. This is incorrect. In computing the dollar value of the repayments received, the rate of exchange in effect at the date of receipt of such repayment should govern.*
V-1 C. B. 289.

Rev. Rul. 58-237, 1958-1 Cum. Bull. 534 (1958) reaches the same conclusion as the earlier ruling but does so under the equivalent of 26 U.S.C. § 905(c) in the Revenue Act of 1939, 53 Stat. 1.** Under the facts of that revenue ruling, the taxpayer had paid an income tax in British pounds to the United Kingdom in 1944 and then received a refund of a portion of that tax in 1954 when the dollar value of the pound was less than when the tax had been paid. Rev. Rul. 58-237 holds

* The vitality of the reasoning in this ruling is not impaired by the fact that the ruling itself was declared obsolete in 1968, Rev. Rul. 68-674, 1968-2 Cum. Bull. 609 (1968) because a declaration of obsolescence "does not mean that the conclusion or underlying rationale has no current applicability." *Bank of America Nat'l Trust & Sav. Ass'n. v. United States*, 459 F.2d 513, 522 n. 14 (9th Cir. 1972), *cert. denied*, 409 U.S. 949 (1972). Moreover, as discussed above, the rationale of this ruling was reaffirmed in Rev. Rul. 58-237, 1958-1 Cum. Bull. 534.

** The equivalent is Section 131(c) of the Revenue Act of 1939, which section also appears in the Statutory Appendix.

that the refund must be valued at the exchange rate when it was received for purposes of making a redetermination with respect to 1944:

Held, in computing the dollar value of a refund of foreign income taxes for which a foreign tax credit had been allowed, the rate of exchange in effect at the date of such refund should be used in converting the foreign currency in which the refund is paid into United States currency. The amount of tax paid for 1944 as redetermined will be the dollar amount of tax previously paid at the exchange rate then in effect, less the amount refunded converted into dollars at the exchange rate prevailing at the date of such refund. 1958-1 Cum. Bull. at 534.

While Rev. Rul. 58-237 does differ from the present case in terms of how the exchange rates fluctuated, there is absolutely nothing in the ruling to indicate that that fact was somehow a necessary element in the conclusion of the IRS. As the District Court properly held, the precise movement of the exchange rate is insignificant for purposes of the method of redetermination established (31A). See E. Owens, *The Foreign Tax Credit* ¶¶ 7/4-7/4B(1961).

What S.M. 4747 and Rev. Rul. 58-237 lay down is a rule that a refund will be valued at the exchange rate in effect when it is received and that the portion refunded will be subtracted from the entire foreign tax credit. By successively reenacting without change Section 131(c) of the 1939 Code and 26 U.S.C. § 905(c), on which this administrative interpretation is based, Congress has given its approval to the method of redetermination that was employed in this case. *Helvering v. Reynolds Co.*, 306 U.S. 110, 116 (1939); *Comprehensive Designers International, Ltd. v. Commissioner*, 66 T.C. 348, 355 (1976) (Tannenwald, J.); *First National City Bank v. United States*, 77-2 USTC ¶ 9527 at 87,741 (Ct. Cl. 1977).

AT&T concedes, as it did below (27A), that according to Rev. Rul. 58-237, a redetermination pursuant to 26 U.S.C. § 905(c) should be made by subtracting the full dollar value of the refund from the original tax credit. See Appellant's Brief at 15. Moreover, AT&T cites as a proper application of this principle a hypothetical example that is identical to the instant case. See Appellant's Brief at 13. Under that example it is assumed that a taxpayer pays 1000 Canadian dollars in taxes at a time when the Canadian dollar and American dollar are equal in value. A foreign tax credit of \$1000 would thus be allowed. It is then further assumed that Canada subsequently refunds a portion of this tax, namely 500 Canadian dollars, at a time when the Canadian dollar is worth \$1.25. The refund is thus worth \$625 and the redetermination pursuant to 26 U.S.C. § 905(c) is undertaken by subtracting \$625 from \$1000 leaving a net credit of \$375. Similarly here, AT&T paid Canadian taxes and received a foreign tax credit of \$976,944.39. Canada then refunded a part of the Canadian taxes at a time when, as in the hypothetical example, the value of the dollar had fallen. The refund was, as in the hypothetical, converted into dollars at this new exchange rate and then subtracted from the total foreign tax credit.

Where appellant falls into error is in arguing that the formula for redetermination prescribed by Rev. Rul. 58-237 requires that the dollar value of the foreign tax refunded must be subtracted only from the dollar amount of the credit attributable to the amount of foreign tax now refunded.* This flies directly in the face of the language of Rev. Rul. 58-237, which indicates that the

* AT&T's reliance upon S.M. 2243, IV-1 C.B. 231 (1925), superseded by Rev. Rul. 70-290, 1970-1 Cum. Bull. 160 (1970) to support this contention is simply misplaced since, unlike Rev. Rul. 58-237, neither of these rulings prescribes a method for redetermination.

minuend for a redetermination is the full dollar amount of the total tax previously paid and not merely the dollar amount attributable to that portion of the tax which has now been refunded. Moreover, appellant's treatment of Rev. Rul. 58-237 is not consistent, since, in the example previously cited, AT&T concedes that when 500 Canadian dollars of tax are refunded at a time when the Canadian dollar is worth \$1.25, the refund should be valued at \$625 and should be subtracted from a minuend, which is the total \$1000 tax credit, and not the \$500 credit attributable to the amount of foreign tax refunded. *See* Appellant's Brief at 13-15. That, however, is precisely the method of redetermination employed here and its correctness is all but admitted by AT&T.

In the final analysis, AT&T's entire attempt to justify its construction of 26 U.S.C. § 905(c) rests upon the flawed premise that its \$976,944.39 foreign tax credit constitutes two separate credits, an approach which simply has no basis in the foreign tax credit provisions of the Internal Revenue Code. The \$976,944.39 paid Canada represented the entire dollar amount of an income tax for which a foreign tax credit was allowed under 26 U.S.C. § 901(b). Hence that amount simply cannot be considered two separate credits, but instead constitutes a single foreign tax credit.* As Judge Carter correctly pointed out:

Both the earlier and later tax assessments were made pursuant to Canada's 15 percent non-resident income tax. As such they are certainly fungible. The refund of the 1967 payment should, therefore, be treated no differently than had all

* AT&T's apparent attempt to bolster its argument on this point by emphasizing that a portion of the Canadian taxes for 1964 was not assessed until 1967, Appellant's Brief at 9, is simply irrelevant because a credit for that assessment was obtained with respect to AT&T's 1964 taxable year.

of the \$976,944.39 paid Canada have been taxed under the same subsection of the Canadian Income Tax Act and \$777,240.79 been refunded (31A).

POINT II

The District Court's construction of 26 U.S.C. § 905 (c) properly implements the policy of the foreign tax credit.

A. The District Court's construction avoids double taxation

A statute should naturally be construed in a manner that carries out its underlying policy. See, e.g., *Corwin Consultants, Inc. v. Interpublic Group of Companies, Inc.*, 512 F.2d 605, 610 (2d Cir. 1975). Ascertaining the policy behind 26 U.S.C. § 905(c) is not difficult since "[t]he basic policy underlying all the foreign tax credit provisions is the elimination of double taxation." *Associated Telephone and Telegraph Company v. United States*, 306 F.2d 824, 832 (2d Cir. 1962), *cert. denied*, 371 U.S. 950 (1963). As one commentator has put it, "... the function of the tax credit is to allow the dollar cost of the foreign creditable tax as an offset against the United States tax ..." E. Owens, *The Foreign Tax Credit*, ¶ 7/4B at 462 (1961).

The construction of 26 U.S.C. § 905(c) sustained by the District Court carries out the policy of the foreign tax credit. For 1964, AT&T had earned certain income and had paid as income taxes to Canada an amount in Canadian dollars that was worth \$976,944.39.* To avoid

* For purposes of the foreign tax credit, the dollar value of the Canadian dollars paid to the Canadian authorities as income tax would be determined at the date of payment. See *Comprehensive Designers International, Ltd. v. Commissioner*, *supra* at 354-356; *First National City Bank v. United States*, *supra* at 87,739-87,742.

double taxation of this same income by the United States, AT&T was allowed a foreign tax credit of \$976,944.39, representing the full dollar amount of the tax that it had paid to Canada. When Canada made a refund of its income taxes worth \$777,240.79, it thus reduced the dollar amount of the Canadian income tax imposed upon AT&T by the dollar amount refunded. The IRS simply had the refund passed through to the United States, leaving AT&T in a situation where double taxation is avoided, just as it was prior to the Canadian tax assessment which resulted in the refund.

That this method of redetermination eliminates double taxation and does so without according the taxpayer a windfall is illustrated by the following example. Let us assume that a taxpayer earns 2000 in Canadian dollars, 1000 of which is taxable under Section 106(1)(a) and 106(1)(b) of the Canadian Income Tax Act and 1000 of which is taxable under Section 106(1)(d). Assume further, for simplicity, that both Canada and the United States have tax rates of 50% and that both tax this income at a time when the American dollar and Canadian dollar are equal in value. The taxpayer would thus owe the United States \$1000 in taxes, but that amount would be offset by a foreign tax credit worth \$1000. In other words, on total income worth \$2000, the taxpayer would have paid \$1000 in taxes, which results in a 50% tax rate and avoids double taxation.

Now let us assume that Canada refunds the 500 in Canadian dollars taxed pursuant to Section 106(1)(d) at a time when a Canadian dollar equals \$1.50. Using the method of redetermination sanctioned by the District Court requires the dollar value of the refund, namely \$750 to be subtracted from the total tax credit of \$1000. This means that the taxpayer will be required to pay the United States \$750 in taxes. While the dollar amount of taxes which the taxpayer had paid to Canada was

\$1000, Canada's refund of taxes worth \$750 means that the dollar amount of taxes paid to Canada has been reduced to \$250.* Hence, the taxpayer has paid \$750 in income tax to the United States and \$250 in income tax to Canada for a total of \$1000. Thus, following this redetermination, \$1000 in taxes has been paid with respect to \$2000 of income which again represents a 50% tax rate and avoids double taxation.

If the approach urged by AT&T is adopted, only \$500 of the refund would be subtracted from the \$1000 credit and the taxpayer would then be taxed on the remaining \$250 of the refund. In short, the taxpayer would pay \$625** in income tax to the United States and \$250*** in income tax to Canada for a total of \$875 with respect to an income of \$2000. This, however, represents an effective tax rate of approximately 44% which provides the taxpayer with a windfall that is wholly unnecessary to avoid double taxation. See E. Owens, *The Foreign Tax Credit* ¶ 7/3C at 456-457 (1961).

The full extent of the distortion which AT&T's approach works upon the policy of the foreign tax credit is revealed by the fact that under AT&T's approach taxation of the \$250 portion of the refund would be reflected in the year when the refund took place. As concerns the year for which redetermination was made, however, the taxpayer would have paid only \$750**** in tax to the

* Full credit for the dollar amount of taxes paid to Canada has been given the taxpayer since subtraction of the \$750 refund from the original \$1000 foreign tax credit leaves a foreign tax credit of \$250, which is equal to the dollar amount of taxes paid to Canada.

** $\$500 + (50\%) (\$250) = \$625$.

*** By making a refund worth \$750, Canada has, as above, reduced to \$250 the dollar amount of taxes paid it.

**** This would be the \$500 by which the foreign tax credit was reduced plus the \$250 dollar amount of the income tax paid to Canada.

United States with respect to income of \$2000 for an effective tax rate of 38%. Moreover, under AT&T's approach the taxpayer obtains a foreign tax credit worth \$500 for a tax payment to Canada worth \$250.

An application of the principles derived from this hypothetical example to the facts of present case confirms that the method of redetermination sanctioned by the District Court was correct. For 1964, AT&T had certain income which was taxed by both the United States and Canada. Canada taxed a portion of that income pursuant to Section 106(1)(a) and Section 106(1)(b) and another portion pursuant to Section 106(1)(d). The former portion yielded taxes worth \$269,085.10 and the latter yielded taxes worth \$707,859.29 for a foreign tax credit of \$976,944.39, representing the dollar amount of creditable income tax paid to Canada. The dollar amount of Canada's income tax was thus allowed as an offset against the American tax imposed upon the same income and double taxation was avoided.*

When Canada made a refund to AT&T worth \$777,240.79 it reduced the dollar amount of foreign tax by that sum. In other words, the refund meant that the dollar amount of taxes paid to Canada was reduced to \$199,703.60, which equals the foreign tax credit resulting from the method of redetermination that the District Court approved. Again the dollar amount of Canada's income tax has been allowed as an offset against the

* If R represents the United States tax rate and X represents the amount of income to be taxed by the United States and D represents the dollar value of foreign tax on this same income then double taxation is avoided by definition when D is allowed as an offset against RX since this means that the taxpayer has paid total tax with respect to X of $D + (RX - D)$ which yields an effective tax rate of R, i.e., $RX = R$.

American tax imposed upon the same income and double taxation has been avoided.*

Employing the method suggested by AT&T, however, results in the taxpayer receiving a foreign tax credit of \$269,085.10 ** even though the dollar amount of taxes paid to Canada has been reduced to \$199,703.60 by Canada's refund of \$777,240.79. In short, AT&T's method of redetermination guarantees the taxpayer a substantial windfall unrelated to the purpose of eliminating double taxation and this windfall is only slightly reduced by the taxation of \$69,381.50 as current income for the year 1972.***

B. Appellant has advanced no valid reason to sustain its construction of 26 U.S.C. § 905(c)

Not only is AT&T's construction of 26 U.S.C. § 905(c) contrary to the policy underlying the foreign tax credit, it finds no support in either the language of the statute

* If X represents the amount of income subject to tax by the U.S. and R represents the U.S. rate of taxation, then the elimination of double taxation can be seen as follows: The amount of tax paid the U.S. was RX —\$976,944.39 and the amount paid Canada was \$976,944.39. Aggregating the two amounts yields a net tax of RX and a tax rate of R . Upon refund of \$777,240.79, that amount is subtracted from the foreign tax credit of \$976,944.39 so that the amount of tax paid the United States is RX —\$199,703.60 and the dollar amount of the tax paid Canada is \$199,703.60. Aggregating the two amounts again yields a total tax of RX and a tax rate of R .

** \$976,944.39 - \$707,859.29.

*** Using the same analysis employed *supra* demonstrates the extent of this windfall. Upon refund of the \$777,240.79, only \$707,859.29 is subtracted from the tax credit of \$976,944.39 so that the amount of tax paid to the United States is RX —\$269,085.10 while the dollar amount of the tax paid to Canada is \$199,703.60. Aggregating these amounts yields a total tax of RX —\$69,381.50 and an effective tax rate which is less than R , i.e., RX - \$69,381.50 and which would remain less than R even if

X

the tax on \$69,381.50 were included in the numerator.

or in sound tax policy. The statute itself speaks of a "redetermination" of tax when a refund occurs, which by definition precludes treating any part of the refund as giving rise to a new taxable event. Yet AT&T would do just that by subtracting only \$707,859.29 from the 1964 tax credit and treating \$69,381.50 as a foreign currency gain that gives rise to a new taxable event in 1972.

AT&T's approach results in an inconsistent construction of Section 905(c) designed only to benefit the taxpayer without regard to the purpose of the foreign tax credit. In effect, appellant maintains that in cases where the value of the dollar has dropped, the foreign tax refunded should be valued according to the exchange rate prevailing when it was paid and the difference between that amount and the dollar amount actually received from the refund should be treated as a foreign currency gain. On the other hand, AT&T contends that, in cases where the value of the dollar has risen, the refund should be valued according to the exchange rate when the refund is made and subtracted from the foreign tax credit, rather than valuing it at the exchange rate when the tax was paid and treating any difference between that amount and the dollar amount actually received from the refund as a foreign currency loss.* Such an inconsistent approach to valuation under Section 905(c) cannot be sustained and is contrary to the administrative interpretation, implicitly approved by Congress, that a refund

* If 1000 Canadian dollars are paid as taxes when the Canadian and American dollars are equal and 500 Canadian dollars are refunded at a time when 1 Canadian dollar equals \$1.25, AT&T's approach would value the refund at \$500 and would treat the \$125 difference between that amount and the \$625 actually received as a foreign currency gain for the year of refund. If the \$500 Canadian dollars are refunded when the Canadian dollar equals \$.75 AT&T maintains that \$375 should be deducted from the \$1000 tax credit rather than valuing the refund at \$500, subtracting that from the \$1000 foreign tax credit and taking the \$125 difference between \$500 and \$375 as a deductible currency loss during the year of refund. Appellant's Brief at 14.

will be valued according to the exchange rate when made.* See *Comprehensive Designers*, *supra* at 354-356 and *First National City Bank*, *supra* at 87,739-87,742 which rejected analogous efforts by taxpayers to construe Section 905(c) in an inconsistent manner designed only to benefit them.**

Appellant really does no more than obscure the issues for decision by interjecting principles concerning the treatment of gain from foreign currency transactions since that approach is not only inconsistently applied by AT&T but divorced from the precise problem of redetermination of tax liability upon refund.*** Equally unavailing is AT&T's reference to 26 U.S.C. § 111 which appellant candidly admits has no direct application here since 26 U.S.C. § 905(c) governs. Appellant's Brief at 19. Moreover, AT&T's argument, derived from a purported analogy with Section 111, that \$69,381.50 of the refund should be treated as an income adjustment for 1972 rather than subtracting it from the 1964 foreign tax credit produces a windfall unnecessary for the relief of double taxation,**** as demonstrated above.

* Rev. Rul. 58-237, 1958-1 Cum. Bull. 534 (1958); S.M. 4747, V-1 C.B. 282 (1926).

** The taxpayers in these cases wanted for purposes of the foreign tax credit to value foreign taxes paid according to the exchange rate prevailing when the taxes were accrued rather than when they were paid because the exchange rate at time of accrual made for a higher tax credit. This attempt to overturn the accepted rule that for purposes of the foreign tax credit taxes are valued when paid was rejected, with both Courts observing that had the exchange rate fluctuated differently the taxpayers would have insisted upon valuing their foreign tax at time of payment.

*** None of the revenue rulings or cases cited by AT&T even purport to deal with 26 U.S.C. § 905(c).

**** As E. Owens, *The Foreign Tax Credit* ¶ 7/3C at 457 (1961) points out in a related context:

Once a tax has been elevated to the position of a credit, an income adjustment . . . is illogical because the tax value given the adjusting item is disproportionate to the tax value of the item being corrected. An income adjustment is logical only when a tax is utilized as a deduction.

AT&T also argues that it should be permitted a windfall from Canada's refund as a needed encouragement for American multinational companies to seek refunds of taxes paid to foreign governments. Appellant's Brief at 22-27. Appellant cites no authority, however, for construing the Internal Revenue Code in a manner designed to afford taxpayers a windfall gain as a form of encouragement.* Moreover, given the accepted construction of 26 U.S.C. § 905(c) that confronted AT&T, such encouragement was apparently not necessary to cause appellant to seek a refund from Canada. Apart from these considerations, however, any taxpayer who pays a foreign tax knowing that it is improperly imposed and who then chooses not to seek a refund from the foreign authorities faces the prospect that his payment will be deemed a contribution to the foreign government and thus not subject to credit against his American income tax. This is made abundantly clear in Rev. Rul. 76-508, 1976-2 Cum. Bull. 225, 226, which holds that:

If a taxpayer is put on notice . . . of the possibility of securing a refund or reduction of foreign income tax liability but fails to pursue its remedies to secure such an adjustment the amounts as to which an adjustment was not sought may be contributions to the foreign government.

See also Rev. Rul. 77-267, 1977-31 I.R.B. 16 (1977), which reiterates this rule. Hence, the multinational taxpayer will have ample incentive to seek a refund by being encouraged to display toward foreign taxing au-

* While the District Court did recognize AT&T's incentive argument as a policy consideration militating against the Government's construction of 26 U.S.C. § 905(c), it properly recognized that that was a matter for legislative consideration. Congress, however, has implicitly sanctioned the method of determination employed here, as discussed at page 8 above.

thorities the same unflinching resolve that is customarily reserved for the IRS.*

Furthermore, it would hardly seem prudent for any corporation to let an incorrect assessment by foreign taxing authorities go unchallenged; for not only is a potentially dangerous precedent set in the foreign country there can never be any permanent guarantee that the Internal Revenue Code will always allow foreign taxes as a full credit against taxes owed the United States. In addition, AT&T's argument on the need for an incentive to seek refunds overlooks the fact that not all refunds emanate from an effort of the taxpayer but instead may well be the result of a remedial provision in the foreign taxing statute such as one designed to refund excess profits taxes during periods of economic recession as was the case in *S.M. 4747*, V-1 C.B. 282 (1926). While the method of redetermination approved by the District Court can be consistently applied to relieve double taxation in all such situations, the approach advanced by AT&T lacks any such consistency and instead is calculated to give the taxpayer a windfall unrelated to the purposes of the foreign tax credit.

Finally, AT&T attempts to sustain its position by resort to a supposed rule of statutory construction requiring all doubts to be resolved in favor of the taxpayer. Appellant's Brief at 28. To the extent that appellant's principal authority, *Gould v. Gould*, 245 U.S. 151 (1917) was intended to establish such a dubious proposition it was overruled by *White v. United States*, 305 U.S. 281, 292 (1938) where the Supreme Court held:

We are not impressed by the argument that, as the question here decided is doubtful all doubts

* Any other approach would mean that an American taxpayer would be rewarded for his failure to contest invalid foreign taxes with a credit against the amount owed the United States.

should be resolved in favor of the taxpayer. It is the function and duty of courts to resolve doubts. We know of no reason why that function should be abdicated in a tax case more than any other where the rights of suitors turn on the construction of a statute and it is our duty to decide what that construction should fairly be.

See also Wolder v. Commissioner, 493 F.2d 608, 611 n.4 (2d Cir. 1974), *cert. denied*, 419 U.S. 828 (1974) where this Court, taking note of *White*, expressly doubted the current validity of the rule of construction now advanced by AT&T.* Indeed, since the foreign tax credit provisions of the Internal Revenue Code represent "an act of grace on the part of Congress," all doubts should be resolved against the taxpayer, particularly since his construction seeks to convert Congressional grace into an unintended windfall. *See Levine v. Commissioner*, 526 F.2d 717, 721 (2d Cir. 1975) (Kaufman, J.); *Irving Air Chute Co. v. Commissioner*, 143 F.2d 256, 259 (2d Cir. 1944), *cert. denied*, 323 U.S. 773 (1944).

* None of the cases cited by AT&T as applying the *Gould* rule, Appellant's Brief at 13, even make reference to *White* or *Wolder* nor do their holdings rest exclusively or even in principal part upon AT&T's preferred rule of construction.

CONCLUSION

For all of the above reasons, appellee respectfully requests that the judgment of the District Court be affirmed.

Dated: New York, New York
September 7, 1977

Respectfully submitted,

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STATUTORY APPENDIX

Statutory Appendix

Can. Rev. Stat. c. 148, s. 106 (1952)

106 (1) Every non-resident person shall pay an income tax of 15% on every amount that a person resident in Canada pays or credits, or is deemed by Part I to pay or credit, to him as, on account or in lieu of payment of, or in satisfaction of,

(a) a management or administration fee or charge;

(b) interest . . .

(c) income of or from an estate trust;

(d) rent, royalty or a similar payment . . .

(e) a timber royalty . . .

(f) alimony or other payment for the support of a spouse or former spouse, children of the marriage, or both the spouse and children of the marriage; or

(g) a patronage dividend . . .

(2) Every non-resident person

(a) shall pay an income tax of 15% on every amount that a person resident in Canada, other than a person described in paragraph (b), pays or credits, to him as, on account or in the lieu of payment of, or in satisfaction of a dividend . . .

Revenue Act of 1918

Section 222(b) If accrued taxes when paid differ from the amounts claimed as credit by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Commissioner who shall redetermine the amount of the tax due under Part II of this title for the year or years affected, and the amount of tax due upon such redetermination, if any, shall be paid by the tax-

payer upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252. In the case of such a tax accrued but not paid, the Commissioner as a condition precedent to the allowance of this credit may require the taxpayer to give a bond with sureties satisfactory to and to be approved by the Commissioner in such penal sum as the Commissioner may require, conditioned for the payment by the taxpayer of any amount of tax found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the Commissioner may require.

(c) These credits shall be allowed only if the taxpayer furnishes evidence satisfactory to the Commissioner showing the amount of income derived from sources within such foreign country or such possession of the United States, and all other information necessary for the computation of such credits.

Section 238. (a) If accrued taxes when paid differ from the amounts claimed as credits by the corporation, or if any tax paid is refunded in whole or in part, the corporation shall at once notify the Commissioner who shall redetermine the amount of the taxes due under this title and under Title III for the year or years affected, and the amount of taxes due upon such redetermination, if any, shall be paid by the corporation upon notice and demand by the collector, or the amount of taxes overpaid, if any, shall be credited or refunded to the corporation in accordance with the provisions of section 252.

Revenue Act of 1939, Section 131(c)

Adjustments on payment of accrued taxes. If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded

in whole or in part, the taxpayer shall notify the Commissioner, who shall redetermine the amount of the tax for the year or years affected, and the amount of tax due upon such redetermination, if any, shall be paid by taxpayer upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 322. In the case of such a tax accrued but not paid the Commissioner as a condition precedent to the allowance of this credit may require the taxpayer to give a bond with sureties satisfactory to and to be approved by the Commissioner in such sum as the Commissioner may require, conditioned upon the payment by the taxpayer of any amount of tax found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the Commissioner may require. In such redetermination by the Commissioner of the amount of tax due from the taxpayer for the year or years affected by a refund, the amount of the taxes refunded for which credit has been allowed under this section shall be reduced by the amount of any tax described in subsection (a) imposed by the foreign country or possession of the United States with respect to such refund; but no credit under this section, and no deduction under section 23, shall be allowed for any taxable year with respect to such tax imposed on the refund. No interest shall be assessed or collected on any amount of tax due upon any redetermination by the Commissioner, resulting from a refund to the taxpayer, for any period prior to the receipt of such refund, except to the extent interest was paid by the foreign country or possession of the United States on such refund for such period.

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AFFIDAVIT OF MAILING

State of New York)
County of New York) ss

 Milton Bader being duly sworn,
deposes and says that he is employed in the Office of the
United States Attorney for the Southern District of New York.

 That on the
 2
 9th day of September 1977 he served ~~a~~ copy of the
within govt's brief

by placing the same in a properly postpaid franked envelope
addressed:

Victor S. Gomperts, Esq.,
195 Broadway
New York, NY 10007

 And deponent further
says he sealed the said envelope and placed the same in the
mail chute drop for mailing in the United States Courthouse Annex,
One St. Andrews Plaza, Borough of Manhattan, City of New York.

Sworn to before me this

9th day of September, 19 77

Pauline P. Troia
PAULINE P. TROIA
Notary Public, State of New York
No. 31-4822381
Qualified in New York County
Commission Expires March 30, 1978

Milton Bader

